TESTIMONY OF KENNETH W. DAM
DEPUTY SECRETARY
UNITED STATES DEPARTMENT OF THE TREASURY
BEFORE THE SENATE COMMITTEE ON FINANCE
REGARDING THE WTO DECISION ON THE EXTRATERRITORIAL INCOME EXCLUSION PROVISIONS AND INTERNATIONAL COMPETITIVENESS

Introduction

Mr. Chairman, Senator Grassley, and distinguished Members of the Committee, I appreciate the opportunity to appear today at this hearing regarding the World Trade Organization (WTO) decision with respect to the extraterritorial income exclusion (ETI) provisions of U.S. tax law and the implications for international competitiveness. I commend the Committee for holding this hearing on this matter of vital importance to U.S. workers and U.S. businesses in today's global marketplace.

On January 29, 2002, the WTO Dispute Settlement Body adopted a final report finding that the ETI provisions are inconsistent with the United States' obligations under the WTO. That decision is the culmination of a challenge brought by the European Union in late 1997 against the foreign sales corporation (FSC) provisions then contained in the U.S. tax law. However, the origins of this dispute go back almost 30 years, predating the World Trade Organization itself. The United States has vigorously pursued this matter and defended its laws because of the importance of the provisions and principles at stake.

A WTO arbitration panel currently is considering the European Union's request for authority from the WTO to impose trade sanctions on $4.043 billion worth of U.S. exports. The arbitration panel is expected to issue its report on the appropriate level of trade sanctions in the next few weeks. Following the issuance of that report, the European Union will be in a position to receive authority to begin imposing trade sanctions on U.S. exports up to the level set by the arbitrators and the authority for such sanctions will continue until the United States rectifies the WTO violation.

This is an urgent matter that requires our immediate attention. The threat of substantial retaliatory sanctions against U.S. exports is not something that any of us takes lightly. Such sanctions, if imposed, would do real damage to U.S. businesses and American workers. And the imposition of such sanctions would have serious adverse consequences for the overall trade relationship between the United States and the European Union beyond those sectors directly targeted with sanctions, which would have a direct and detrimental effect on U.S. consumers. Of course the urgency is not just about the critical need to avert costly retaliation. The WTO has issued its final decision in this case, and we must comply with that decision. That is a matter of principle.

The President has spoken on this and his message is clear. The United States will honor its WTO obligations and will come into compliance with the recent WTO decision. To do so will require legislation to change our tax law. The Administration is committed to

working closely with the Congress in the development and enactment of the legislation necessary to bring the United States into compliance with WTO rules.

The analysis of the current WTO rules reflected in the decision in the FSC/ETI case makes it apparent that legislation attempting to replicate FSC or ETI benefits will not pass muster in the WTO. Nor can we satisfy our WTO obligations and comply with WTO rules through "tweaks" to the ETI provisions. The WTO Appellate Body made clear that a benefit tied to export activity, such as is provided through the ETI provisions, is not permitted. Therefore, it will not be fruitful to pursue again a replacement of the ETI provisions.

Addressing the WTO decision through the tax law will require real and meaningful changes to our current international tax laws. While the WTO decision is a bitter pill, we must look forward and take a fresh look at our tax laws and the extent to which they enhance or harm the position of the U.S. in the global marketplace. As we evaluate the changes we might consider, it is imperative that we make choices that will enhance – and not adversely affect - the competitive position of American workers and U.S.-based businesses in today's global marketplace.

In stating his commitment to compliance in this case, the President has said we must focus on enhancing America's competitiveness in the global marketplace because that is the key to protecting American jobs. At its core, this case raises fundamental questions regarding a level global playing field with respect to tax policy. The ETI provisions, like the FSC provisions that preceded them, represent an integral part of our larger system of international tax rules. These provisions were designed to help level the global playing field for U.S.-based businesses that are subject to those international tax rules. In modifying our tax laws to comply with this decision, we must not lose sight of that objective and what it means: the health of the US economy and the jobs of American workers.

Much can be done to rationalize our international tax rules through reforms both small and large. The need for reform of our international tax rules is something I know you recognize, Mr. Chairman. You have lead the way on a bipartisan basis with proposals to reform our international tax rules. The U.S. international tax rules can operate to impose a burden on U.S.-based companies that is disproportionate to the tax burden imposed by our trading partners on the foreign operations of their companies. The U.S. rules for the taxation of foreign-source income are unique in their breadth of reach and degree of complexity. The recent activity involving so-called corporate inversion transactions is evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for U.S. businesses and the U.S. economy. Foreign acquisition of U.S. multinationals that arises out of distortions created by our international tax system raises similar concerns. We must address these tax disadvantages to reduce the tilt away from American workers and U.S.-based companies. And as we consider appropriate reform of our system of international tax rules, we should not underestimate the benefits to be gained from reducing the complexity of the current rules.

The bottom line is clear and simple. Our economy is truly global. U.S.-based companies must be able to compete in today's global marketplace. Our system of international tax rules should not disadvantage them in that competition. If we allow our international tax rules to act as an impediment to successful competition, the cost will be measured in lost opportunities and lost jobs here at home.

While we work toward the needed changes to our international tax rules, we must continue a dialogue with the European Union. We must take every step needed to ensure that this dispute does not further escalate to the detriment of the global trading environment. It is essential that we achieve a resolution of this matter that is clear, fair and final – a resolution that protects America's interests and satisfies our obligations under the WTO.

As I said in opening, resolving this case is an urgent matter that requires our immediate attention. We must work toward enactment of legislation that will bring us into compliance with the international WTO rules and protect the interests of American workers and businesses. On this there can be no delay – we must make real progress now.

However, this case highlights significant issues requiring further consideration as the discussions regarding WTO matters continue in the new round. As I said in my opening statement in the WTO appellate proceeding in this case in Geneva last November, "few things are as central to a country's sovereignty as how it raises revenue." The WTO Appellate Body in its report in the FSC case stated that the WTO rules do not "compel Members to choose a particular kind of tax system." That is a critically important point.

Compliance with the WTO decision in this case will require that we make meaningful changes to our tax law. We have an obligation to U.S. workers and businesses not simply to eliminate the ETI provisions. Our commitment to the American worker requires that we protect the competitive position of our businesses. We must couple the changes needed to address the WTO decision with needed reforms of our tax rules that will help level the playing field for U.S.-based businesses that must compete in today's global marketplace. The reforms that are needed address basic inequities in our international tax rules, rules that are out of step with those of our major trading partners. Such reform to the U.S. international tax system is not a matter in which there is any role for the WTO to play.

This case has been about the application of WTO rules to a particular aspect of the U.S. income tax system. However, there is a much more fundamental question regarding the treatment of taxes under the WTO rules that demands our careful consideration. The WTO rules on prohibited export subsidies make a distinction between direct taxes, such as income taxes, and indirect taxes, such as value added taxes. Under the WTO agreements, direct taxes are not permitted to be border adjustable. Therefore, the U.S. income tax is not rebatable on export under these rules. In contrast, indirect taxes are

permitted to be border adjustable under the WTO rules. Accordingly, the European value added taxes may be, and are, rebated at the border consistent with WTO rules.

This disparity in treatment between direct and indirect taxes dates back formally to a 1960 GATT working party and its informal origins date back even farther. Notwithstanding this long history, there is no compelling rationale for disparate treatment of direct and indirect taxes. Reconsideration of this distinction in the treatment of direct and indirect taxes under the WTO rules will be part of the discussion of WTO matters in the new round. These negotiations, however, are not a strategy for addressing the compliance obligation we face in this case today.

I would like to turn now to a brief history of the WTO case and our tax provisions that have been the subject of this protracted litigation. I will conclude with a discussion of the international competitiveness issues that must be a central focus in formulating the tax law changes needed to satisfy our WTO obligations and protect the interests of U.S. businesses and workers.

Overview of the History of the WTO Case

The FSC provisions were enacted in 1984. They provided an exemption from U.S. tax for a portion of the income earned from export transactions. This partial exemption from tax was intended to provide U.S. exporters with tax treatment that was more comparable to the treatment provided to exporters under the tax systems common in other countries.

The FSC provisions were enacted to resolve a General Agreement on Tariffs and Trade (GATT) dispute involving a prior U.S. tax regime – the domestic international sales corporation (DISC) provisions enacted in 1971. Following a challenge to the DISC provisions brought by the European Union and a counter-challenge to several European tax regimes brought by the United States, a GATT panel in 1976 ruled against all the contested tax measures. This decision led to a stalemate that was resolved with a GATT Council Understanding adopted in 1981 (the "1981 Understanding"). Pursuant to this 1981 Understanding regarding the treatment of tax measures under the trade agreements, the United States repealed the DISC provisions and enacted the FSC provisions.

The European Union formally challenged the FSC provisions in the WTO in November 1997. Consultations to resolve the matter were unsuccessful, and the EU challenge was referred to a WTO dispute resolution panel. In October 1999, the WTO panel issued a report finding that the FSC provisions constituted a violation of WTO rules. The United States appealed the panel report; the European Union also appealed the report. In February 2000, the WTO Appellate Body issued its report substantially upholding the findings of the panel.

Although the United States argued forcefully that the FSC provisions were blessed by the 1981 Understanding, the WTO panel disagreed, concluding that the 1981 Understanding had no continuing relevance in the interpretation of current WTO rules. The panel's analysis focused mainly on the application of the WTO Agreement on Subsidies and

Countervailing Measures. The panel found that the FSC provisions constituted a prohibited export subsidy under the Subsidies Agreement.

In response to the WTO decision against the FSC provisions, the FSC Repeal and Extraterritorial Income Exclusion Act was enacted on November 15, 2000. The legislation repealed the FSC provisions and adopted in their place the ETI provisions. The legislation was intended to bring the United States into compliance with WTO rules by addressing the analysis reflected in the WTO decision. At the same time, the legislation also was intended to ensure that U.S. businesses not be foreclosed from opportunities in the global marketplace because of differences in the U.S. tax laws as compared to the laws of other countries.

Immediately following the enactment of the ETI Act, the European Union brought a challenge in the WTO. In August 2001, a WTO panel issued a report finding that the ETI provisions also violate WTO rules. The panel report contained sweeping language and conclusory statements that had broad implications beyond the case at hand. Because of the importance of the issues involved and the troubling implications of the panel's analysis, the United States appealed the panel report. The WTO Appellate Body generally affirmed the panel's findings, although it modified and narrowed the panel's analysis in some respects. The Dispute Settlement Body adopted the report as modified by the Appellate Body on January 29, 2002.

The Appellate Body report makes four main findings with respect to the ETI provisions: (1) the ETI provisions constitute a prohibited export subsidy under the WTO Subsidies Agreement; (2) the ETI provisions constitute a prohibited export subsidy under the WTO Agriculture Agreement; (3) the limitation on foreign content contained in the ETI provisions violate the national treatment provisions of Article III:4 of GATT; and (4) the transition rules contained in the ETI Act violate the WTO's prior recommendation that the FSC subsidy be withdrawn with effect from November 1, 2000.

When it challenged the ETI Act in November 2000, the European Union simultaneously requested authority from the WTO to impose trade sanctions on $4.043 billion worth of U.S. exports. The United States responded by initiating a WTO arbitration proceeding on the grounds that the amount of trade sanctions requested by the European Union was excessive under WTO standards. This arbitration was suspended pending the outcome of the European Union's challenge to the WTO-consistency of the ETI Act, and resumed on January 29th with the Dispute Settlement Body's adoption of its final report. As I noted at the outset, the arbitration panel is expected to issue its report on the appropriate level of trade sanctions in the next few weeks and, following the issuance of that report, the European Union will be in a position to be authorized to begin imposing trade sanctions on U.S. exports up to the level set by the arbitrators.

Competitiveness and U.S. Tax Policy

The U.S. international tax rules have developed in a patchwork fashion, beginning during the 1950s and 1960s. They are founded on policies and principles developed during a

time when America's foreign direct investment was preeminent abroad, and competition from imports to the United States was scant. Today, we have a truly global economy, in terms of both trade and investment. The value of goods traded to and from the United States increased more than three times faster than GDP between 1960 and 2000, rising to more than 20 percent of GDP. The flow of cross-border investment, both inflows and outflows, rose from a scant 1.1 percent of GDP in 1960 to 15.9 percent of GDP in 2000.

Multinational corporations are a vital part of the United States economy. The ability of U.S. multinational corporations to compete successfully abroad leads directly to their employment of American workers at home. They employ over 20 million people in the United States, or about one in every six American workers. Approximately one fourth of the output produced by U.S. workers and U.S.-owned companies is produced by U.S. non-bank multinationals, either at home or abroad. Multinationals in the manufacturing sector produce over half of all U.S. gross manufactured product.

U.S. multinationals also participate substantially in international trade. Their merchandise exports account for about two-thirds of overall U.S. merchandise exports. Their merchandise imports account for about 40 percent of all U.S. merchandise imports. On balance, the operations of these companies showed a net trade surplus of $64 billion in 1999.

Multinational companies compete abroad to increase their sales in foreign markets, which increases their worldwide earnings. Much of their foreign activities are aimed at providing services that cannot be exported and selling goods that are costly to export due to transportation costs, tariffs, and local content requirements. About one third of the gross product of foreign affiliates of U.S. multinationals is produced by affiliates in the service sector, including distribution, marketing, and servicing U.S. exports. Foreign investment is also undertaken to obtain access to natural resources abroad.

Among the most important assets of U.S. multinationals is their technical and scientific expertise. Their foreign investments broaden the opportunities to benefit from such expertise and thus encourage them to spend more on research and development. Spending on research and development allows the United States to maintain its competitive advantage in business and be unrivaled as the world leader in scientific and technological know-how. In 1999, non-financial U.S. multinationals performed $142 billion of research and development. Nearly 90 percent of this activity was located in the United States. It accounted for more than two thirds of all research and development conducted by companies in the United States.

At one time, the strength of America's economy was thought to be tied to its abundant natural resources. Today, America's strength is its ability to innovate: to create new technologies and to react faster and smarter to the commercialization of these technologies. America's preeminent resource today is its knowledge base.

A feature of a knowledge-driven economy is that unlike physical capital, technological know-how has the potential to be applied across the world without reducing the

productive capacity of the United States. For example, computer software designed to enhance the efficiency of a manufacturing process may require substantial upfront investment, but once completed it can be employed around the world by its developer without diminishing the benefits of the know-how within the United States. Foreign direct investment by companies in a knowledge-driven economy provides opportunities to export this know-how at low cost and provides incentives to undertake greater domestic investment in developing these sources of competitive advantage.

There are many reasons to believe that the principles that guided U.S. international tax policy in the past should be reconsidered in today's highly competitive, knowledge-driven economy. In this regard, it is significant that the U.S. tax system differs in fundamental ways from those of our major trading partners. In order to ensure that U.S. workers achieve higher living standards, we must ensure the U.S. tax rules do not hinder the ability of the U.S. businesses that employ them to compete on a global scale. If U.S. workers and businesses are to succeed in the global economy, the U.S. tax system must not generate a bias against their ability to compete effectively with foreign-based companies.

To understand the effect of U.S. tax policy on the competitiveness of U.S. business, we must consider how U.S. businesses compete in today's global marketplace. A U.S. business operating at home and abroad must compete in several ways for capital and customers. Competition may be among:

- U.S.-managed firms that produce within the United States;
- U.S.-managed firms that produce abroad;
- Foreign-managed firms that produce within the United States;
- Foreign-managed firms that produce abroad within the foreign country in which they are headquartered; and
- Foreign-managed firms that produce abroad within a foreign country different from the one in which they are headquartered.

These entities may be simultaneously competing for sales within the United States, within a foreign country against local foreign production (either U.S., local, or other foreign managed), or within a foreign country against non-local production. Globalization requires that U.S. companies be competitive both in foreign markets and at home.

Other elements of competition among firms exist at the investor level: U.S.-managed firms may have foreign investors and foreign-managed firms may have U.S. investors. Portfolio investment accounts for approximately two-thirds of U.S. investment abroad and a similar fraction of foreign investment in the United States. Firms compete in global capital markets as well as global consumer markets.

In a world without taxes, competition among these different firms and different markets would be determined by production costs. In a world with taxes, however, where countries make different determinations with respect to tax rates and tax bases, these

competitive decisions inevitably are affected by taxes. Assuming other countries make sovereign decisions on how to establish their own tax systems and tax rates, it simply is not possible for the United States to establish a tax system that restores the same competitive decisions that would have existed in a world without taxes.

The United States can, for example, attempt to equalize the taxation of income earned by U.S. companies from their U.S. exports to that of U.S. companies producing abroad for the same foreign market. However, in equalizing this tax burden, it may be the case that the U.S. tax results in neither type of U.S. company being competitive against a foreign-based multinational producing for sale in this foreign market.

The manner in which balance is achieved among these competitive concerns changes over time as circumstances change. For example, as foreign multinationals have increased in their worldwide position, the likelihood of a U.S. multinational company competing against a foreign multinational in a foreign market has increased relative to the likelihood of U.S. export sales competing against sales from a U.S. multinational producing abroad. The desire to restore competitive decisions to those that would occur in the absence of taxation therefore may place greater weight today on U.S. taxes not impeding the competitive position of U.S. multinationals vis-à-vis foreign multinationals in the global marketplace. Similarly, while at one time U.S. foreign production may have been thought to be largely substitutable with U.S. domestic production for export, today it is understood that foreign production may provide the opportunity for the export of firm-specific know-how and domestic exports may be enhanced by the establishment of foreign production facilities through supply linkages and service arrangements. Ensuring the ability of U.S. multinationals to compete in foreign markets thus provides direct opportunities at home for American workers.

Given the significance today of competitiveness concerns, it is important to understand the major features of the U.S. tax system and how they differ from those of our major trading partners. The primary features of the U.S. tax system considered here are: (i) the taxation of worldwide income; (ii) the current taxation of certain types of active foreign-source income; (iii) the limitations placed on the use of foreign tax credits; and (iv) the unintegrated taxation of corporate income at both the entity level and the individual level.

U.S. Worldwide Tax System

The United States, like about half of the OECD countries, including the United Kingdom and Japan, operates a worldwide system of income taxation. Under this worldwide approach, U.S. citizens and residents, including U.S. corporations, are taxed on all their income, regardless of where it is earned. Income earned from foreign sources potentially is subject to taxation both by the country where the income is earned, the country of source, and by the United States, the country of residence. To provide relief from this potential double taxation, the United States allows taxpayers a foreign tax credit that reduces the U.S. tax on foreign-source income by the amount of foreign income and withholding taxes paid on such income.

The U.S. worldwide system of taxation is in contrast to the territorial tax systems operated by the other half of the OECD countries, including Canada, Germany, France, and the Netherlands. Under these territorial tax systems, domestic residents and corporations generally are subject to tax only on their income from domestic sources. A domestic business is not subject to domestic taxation on the active income earned abroad by a foreign branch or on dividends paid from active income earned by a foreign subsidiary. A domestic corporation generally is subject to tax on other investment-type income, such as royalties, rent, interest, and portfolio dividends, without regard to where such income is earned; because this passive income is taxed on a worldwide basis, relief from double taxation generally is provided through either a foreign tax credit or a deduction allowed for foreign taxes imposed on such income. This type of territorial tax system sometimes is referred to as a "dividend exemption" system because active foreign business income repatriated in the form of a dividend is exempt from taxation. By contrast, a pure territorial system would provide an exemption for all income received from foreign sources, including investment-type income. Such pure territorial systems have existed only in a few developing countries.

Differences between a worldwide tax system and a territorial system can affect the ability of U.S.-based multinationals to compete for sales in foreign markets against foreign-based multinationals. The key difference between the two systems is which tax rate – source country or home country – applies to foreign-source income. Under a worldwide tax system, repatriated foreign income is taxed at the higher of the source country rate or the residence country rate. In contrast, foreign income under a territorial tax system is subject to tax at the source country rate. The effect of this difference depends on how the tax rate in the country where the income is earned compares to the tax rate in the company's home country. The effect on U.S.-based businesses depends upon their mix of foreign-source income, but the imposition of residual U.S. tax on income earned abroad can impose a cost for U.S. businesses that is not imposed on their foreign competitors. Differences between these systems also can affect decisions about whether and when to repatriate earnings, which in turn affect investment decisions in the United States.

It is important to note that both worldwide and territorial systems involve the taxation of income. The complexities present in taxing income generally are heightened in determining the taxation of income from multinational activities, where in addition to measuring the income one must determine its source (foreign or domestic). This complexity affects both tax administrators and taxpayers. Indeed, the U.S. international tax rules have been identified as one of the largest sources of complexity facing U.S. corporate taxpayers.

Given the complexity of the task of taxing multinational income under a worldwide or territorial system on top of the general complexity of the income tax system, some consideration might be given to alternative tax bases other than income. Other OECD countries typically rely on taxes on goods and services, such as under a value added tax, for a substantial share of tax revenues. In the European OECD countries, for example,

these taxes raise nearly five times the amount of revenue as does the U.S. corporate income tax as a share of GDP.

Comparison with Other Worldwide Tax Systems

As described above, about half of the OECD countries employ a worldwide tax system as does the United States. However, the details of our system are such that U.S. multinationals may be disadvantaged when competing abroad against multinational companies established in other countries using a worldwide tax system. This is because the United States employs a worldwide tax system that, unlike other worldwide systems, taxes active forms of business income earned abroad before it has been repatriated and more strictly limits the use of the foreign tax credits that prevent double taxation of income earned abroad.

Limitations on Deferral

Under the U.S. international tax rules, income earned abroad by a foreign subsidiary generally is subject to U.S. tax at the U.S. parent corporation level only when such income is distributed by the foreign subsidiary to the U.S. parent in the form of a dividend. An exception to this general rule is provided with the rules of subpart F of the Code, under which a U.S. parent is subject to current U.S. tax on certain income of its foreign subsidiaries, without regard to whether that income is actually distributed to the U.S. parent. The focus of the subpart F rules is on passive, investment-type income that is earned abroad through a foreign subsidiary. However, the reach of the subpart F rules extends well beyond passive income to encompass some forms of income from active foreign business operations. No other country has rules for the immediate taxation of foreign-source income that are comparable to the U.S. rules in terms of breadth and complexity. The effect of these rules is to force U.S.-based companies either to structure their operations in a manner that is less than optimal from a business perspective or to incur current U.S. tax in addition to the local tax. The foreign-based companies against which our companies must compete do not face this same tradeoff.

Several categories of active business income are covered by the subpart F rules. Under subpart F, a U.S. parent company is subject to current U.S. tax on income earned by a foreign subsidiary from certain sales transactions. Accordingly, a U.S. company that uses a centralized foreign distribution company to handle sales of its products in foreign markets is subject to current U.S. tax on the income earned abroad by that foreign distribution subsidiary. In contrast, a local competitor making sales in that market is subject only to the tax imposed by that country. Moreover, a foreign competitor that similarly uses a centralized distribution company to make sales into the same markets also generally will be subject only to the tax imposed by the local country. This rule has the effect of imposing current U.S. tax on income from active marketing operations abroad. U.S. companies that centralize their foreign distribution facilities therefore face a tax penalty not imposed on their foreign competitors. This increases the cost of selling goods that are produced in the United States.

The subpart F rules also impose current U.S. taxation on income from certain services transactions performed abroad. In addition, a U.S. company with a foreign subsidiary engaged in shipping activities or in certain oil-related activities, such as transportation of oil from the source to the consumer, will be subject to current U.S. tax on the income earned abroad from such activities. In contrast, a foreign competitor engaged in the same activities generally will not be subject to current home-country tax on its income from these activities. These rules operate to subject U.S.-based companies to an additional tax cost on some classes of income arising from active business operations structured and located in a particular country for business reasons wholly unrelated to any tax considerations.

Limitations on Foreign Tax Credits

Under the worldwide system of taxation, income earned abroad potentially is subject to tax in two countries – the taxpayer's country of residence and the country where the income was earned. Relief from this potential double taxation is provided through the mechanism of a foreign tax credit, under which the tax that otherwise would be imposed by the country of residence may be offset by tax imposed by the source country. The United States allows U.S. taxpayers a foreign tax credit for taxes paid on income earned outside the United States.

The foreign tax credit may be used only to offset U.S. tax on foreign-source income and not to offset U.S. tax on U.S.-source income. The rules for determining and applying this limitation are detailed and complex and can have the effect of subjecting U.S.-based companies to double taxation on their income earned abroad. The current U.S. foreign tax credit regime also requires that the rules be applied separately to separate categories or "baskets" of income. Foreign taxes paid with respect to income in a particular category may be used only to offset the U.S. tax on income from that same category. Computations of foreign and domestic source income, allocable expenses, and foreign taxes paid must be made separately for each of these separate foreign tax credit baskets, further adding to the complexity of the system. Moreover, the U.S. foreign tax credit regime requires the allocation of U.S. interest expense against foreign-source income in a manner that reduces the foreign tax credit limitation by understating foreign income. The practical effect of these interest allocation rules can be the denial of a deduction for interest expense incurred in the United States, which increases the cost of investment and expansion here at home.

Other countries do not have restrictions and limitations on foreign tax credits that are nearly as extensive as our rules. These rules can have the effect of denying U.S.-based companies the full ability to credit foreign taxes paid on income earned abroad against the U.S. tax liability with respect to that income. The result is that U.S.-based companies are subject to just the double taxation that the foreign tax credit is intended to eliminate.

U.S. Corporate Taxation

While concern about the effects of the U.S. tax system on international competitiveness may focus on the tax treatment of foreign-source income, competitiveness issues arise in very much the same way in terms of the general manner in which corporate income is subject to tax in the United States.

One aspect of the U.S. tax system is that the income from an equity-financed investment in the corporate sector is taxed twice. Equity income, or profit, is taxed first under the corporate income tax. Profit is taxed again under the individual income tax when received by the shareholder as a dividend or as a capital gain on the appreciation of corporate shares. In contrast, most other OECD countries offer some form of integration, under which corporate tax payments are either partially or fully taken into consideration when assessing shareholder taxes on this income, eliminating or reducing the double tax on corporate profits.

The non-integration of corporate and individual tax payments on corporate income applies equally to domestically earned income or foreign-source income of a U.S. company. This double tax increases the "hurdle" rate, or the minimum rate of return required on a prospective investment. In order to yield a given after-tax return to an individual investor, the pre-tax return must be sufficiently high to offset both the corporate level and individual level taxes paid on this return. Whether competing at home against foreign imports or competing abroad through exports from the United States or through foreign production, the double tax makes it more difficult for the U.S. company to compete successfully against a foreign competitor.

As noted above, most OECD countries offer some form of tax relief for corporate profits. This integration typically is provided by reducing personal income tax payments on corporate distributions rather than by reducing corporate level tax payments. International comparisons of corporate tax burdens, however, sometimes fail to account for differences in integration across countries and consider only corporate level tax payments. To be meaningful, comparisons between the total tax burden faced on corporate investments by U.S. companies and those of foreign multinational companies must take into account the total tax burden on corporate profits at both the corporate and individual levels.

Closing Thoughts

The U.S. economy is an integral part of the global marketplace, and the activities of U.S. businesses in the global marketplace are a critical part of America's economic success. Accordingly, we must ensure that U.S. tax rules do not adversely impact the ability of American workers and U.S. businesses to compete successfully around the world. Relative to the tax systems of our major trading partners, the U.S. international tax rules can impose significantly heavier burdens on domestically based companies. As we make the changes to our tax law that are needed to comply with WTO rules, we must keep our focus on the objectives served by the FSC and ETI provisions and look to removing biases against the ability of U.S. businesses to compete in today's global economy. Such

reforms will allow the United States to retain its world economic leadership to the benefit of American workers.

The Administration is committed to working with Congress to satisfy the twin objectives of meeting our WTO obligations and ensuring that we protect the competitive position of American workers and businesses.